Americans for Financial Reform
Accountability, Fairness, Security

Support Strong Protections for Investors

Investor Protection Act of 2009 (H.R. 3817)

A side-effect of last year's market collapse was its exposure of the Madoff investment fraud. The subsequent investigation into the regulatory failure that allowed this multi-billion-dollar Ponzi scheme to operate undetected for decades revealed glaring weaknesses in the Securities and Exchange Commission's oversight of the securities markets and protections for investors. The Investor Protection Act contains a variety of measures to enhance the ability of the SEC to detect and prosecute fraud, including increasing the agency's authorized funding, strengthening its enforcement tools, and providing new protections for whistleblowers. It also includes measures to address long neglected gaps in investor protection. The most important of these would require brokers who give investment advice to act in their customers' best interests and would authorize the SEC to limit the use of mandatory arbitration clauses.

Require All Who Give Investment Advice to Act in Customers' Best Interests

Overwhelmed and intimidated, most investors choose to rely on a professional – whether a broker, a financial planner, or an investment adviser – to help them to make the investment decisions upon which their retirement security and long-term savings success depend. Most approach this relationship with their guard down, relying heavily, if not exclusively, on the recommendations they receive. This leaves them extremely vulnerable, particularly given the conflicts of interest that pervade the securities industry.

Our current regulatory approach contributes to this problem by applying very different standards to services that are indistinguishable to the average investor. Specifically, while investment advisers are held to a fiduciary duty to act in the best interests of their clients, brokers who offer investment advice are required only to make recommendations that are generally suitable for the investor. Moreover, this lower standard for brokers has continued to apply even as they rebranded their salespeople as financial advisers and their services as investment planning. As a result, these "financial advisers" are free to offer higher cost, poorer performing investment options that pay them a higher commission as long as the option is generally suitable. And, since none of this has to be disclosed, the typical investor never knows the difference.

The IPA seeks to rectify this problem by requiring the SEC to issue rules applying the same fiduciary duty to investment advice by brokers that applies under the Advisers Act. The legislation makes clear that brokers would still be able to charge commissions for their services and would still be permitted to sell from a limited menu of investment options so long as appropriate disclosures were provided. Unfortunately, an amendment was added during mark-up that would

permit the SEC to make FINRA, the broker-dealer self-regulatory organization, responsible enforcing the requirement for its member firms and persons associated with those firms. This would leave primary responsibility for determining how the fiduciary standard would apply to the vast majority of investment advisers in the hands of an organization that is infused with the broker-dealer mindset and has until very recently adamantly opposed holding brokers to a fiduciary standard when they give advice.

AFR supports an amendment to strip Finra of this oversight authority and opposes any amendment to further limit the scope of the fiduciary duty.

Support an End to Forced Arbitration

Since the 1980s, brokers have been free to force customers to sign pre-dispute binding arbitration clauses. As a result, investors today must agree to resolve disputes in an industry-run system many perceive as biased as a condition of opening an account. If investors were allowed a choice of whether or where to arbitrate disputes, the industry-run system would have to compete for their business by offering a system that all parties perceive as fair, efficient and affordable. The Investor Protection Act would promote that outcome by requiring the SEC to conduct a study and permitting the agency to limit or ban the use of binding arbitration clauses if it found them to be contrary to the interests of investors.

Restore Anti-Fraud Protections

Earlier this fall, in a move cheered by retail and institutional investors, the SEC voted to begin long-delayed implementation of post-Enron accounting reforms at companies with under $75 million in market capitalization. Specifically, the Commission voted to require these companies to begin complying next year with the requirement that their independent auditor include in the annual financial statement audit an evaluation of the company's controls to prevent accounting fraud and errors. The requirement is particularly important to protect investors in small companies, since these companies are more prone to both accounting fraud and financial reporting errors than larger companies and since, when fraud occurs at these companies, it almost always involves the complicity of senior management. Implementation had repeatedly been delayed, however, as regulators sought to reduce the costs of compliance. The SEC voted to proceed after having extensively revised the requirement to make it less prescriptive and more scalable based on the size and complexity of the company and after thorough study showed that compliance costs had dropped dramatically since those revisions were made.

Ignoring the revisions to the standard and the cost reductions that have resulted, as well as the devastating costs that accounting fraud and financial restatements impose on investors, the Committee adopted an amendment to the IPA that would provide roughly half of all public companies with a permanent exemption from the requirement. They

justified their action using precisely the same twisted logic that landed us in the current financial crisis: that regulation is a luxury we can't afford.

AFR supports an amendment to strip the anti-investor exemption from Sarbanes-Oxley Act requirements for small public companies.

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